AMERISAFE INC
Form 10-K
March 05, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K
ANNUAL REPORT
PURSUANT TO SECTIONS 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006
Commission File Number: 000-51520
AMERISAFE, INC.
(Exact Name of Registrant as Specified in Its Charter)

Texas	**75-2069407**
(State of Incorporation)	(I.R.S. Employer Identification Number)
2301 Highway 190 West, DeRidder, Louisiana	**70634**
(Address of Principal Executive Offices)	(Zip Code)

Registrant s telephone number, including area code: **(337) 463-9052**
Securities registered pursuant to Section 12(b) of the Act:

Title of Class	Name of Each Exchange on Which Registered
Common Stock, par value $0.01 per share	**Nasdaq Stock Market LLC**

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2).

Large Accelerated Filer o Accelerated Filer þ Non-Accelerated Filer o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The aggregate market value of the voting common stock held by non-affiliates of the Registrant as of June 30, 2006 (the last business day of the Registrant s most recently completed second fiscal quarter) was approximately $120.1 million, based upon the closing price of the shares on the NASDAQ Global Select Market on that date.

As of February 20, 2007, there were 18,708,898 shares of the Registrant s common stock, par value $.01 per share, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s Proxy Statement relating to the 2007 Annual Meeting of Shareholders are incorporated by reference in Items 10, 11, 12, 13 and 14 of Part III of this report.

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FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and 21E of the Securities Exchange Act of 1934. You should not place undue reliance on these statements. These forward-looking statements include statements that reflect the current views of our senior management with respect to our financial performance and future events with respect to our business and the insurance industry in general. Statements that include the words expect, intend, plan, believe, project, forecast, estimate, may, shoul similar statements of a future or forward-looking nature identify forward-looking statements. Forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause our actual results to differ materially from those indicated in these statements. We believe that these factors include, but are not limited to, the following:

- increased competition on the basis of coverage availability, claims management, safety services, payment terms, premium rates, policy terms, types of insurance offered, overall financial strength, financial ratings and reputation;
- the cyclical nature of the workers compensation insurance industry;
- greater frequency or severity of claims and loss activity, including as a result of natural or man-made catastrophic events, than our underwriting, reserving or investment practices anticipate based on historical experience or industry data;
- changes in rating agency policies or practices;
- changes in the availability, cost or quality of reinsurance and the failure of our reinsurers to pay claims in a timely manner or at all;
- negative developments in the workers compensation insurance industry;
- decreased level of business activity of our policyholders;
- decreased demand for our insurance;
- changes in regulations or laws applicable to us, our policyholders or the agencies that sell our insurance;
- changes in legal theories of liability under our insurance policies;
- developments in capital markets that adversely affect the performance of our investments;
- loss of the services of any of our senior management or other key employees;
- the effects of U.S. involvement in hostilities with other countries and large-scale acts of terrorism, or the threat of hostilities or terrorist acts; and
- changes in general economic conditions, including interest rates, inflation and other factors.

The foregoing factors should not be construed as exhaustive and should be read together with the other cautionary statements included in this report, including under the caption Risk Factors in Item 1A of this report. If one or more events related to these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may differ materially from what we anticipate.

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PART I

Item 1. Business.

Overview

We are a specialty provider of workers compensation insurance focused on small to mid-sized employers engaged in hazardous industries, principally construction, trucking, logging, agriculture, oil and gas, maritime and sawmills. Since commencing operations in 1986, we have gained significant experience underwriting the complex workers compensation exposures inherent in these industries. We provide coverage to employers under state and federal workers compensation laws. These laws prescribe wage replacement and medical care benefits that employers are obligated to provide to their employees who are injured in the course and scope of their employment. Our workers compensation insurance policies provide benefits to injured employees for, among other things, temporary or permanent disability, death and medical and hospital expenses. The benefits payable and the duration of those benefits are set by state or federal law. The benefits vary by jurisdiction, the nature and severity of the injury and the wages of the employee. The employer, who is the policyholder, pays the premiums for coverage.

Hazardous industry employers tend to have less frequent but more severe claims as compared to employers in other industries due to the nature of their businesses. Injuries that occur are often severe in nature including death, dismemberment, paraplegia and quadriplegia. As a result, employers engaged in hazardous industries pay substantially higher than average rates for workers compensation insurance compared to employers in other industries, as measured per payroll dollar. The higher premium rates are due to the nature of the work performed and the inherent workplace danger of our target employers. For example, our construction employers generally paid premium rates equal to $7.78 per $100 of payroll to obtain workers compensation coverage for all of their employees in 2006.

We employ a proactive, disciplined approach in underwriting employers and providing comprehensive services intended to lessen the overall incidence and cost of workplace injuries. We provide safety services at employers workplaces as a vital component of our underwriting process and to promote safer workplaces. We utilize intensive claims management practices that we believe permit us to reduce the overall cost of our claims. In addition, our audit services ensure that our policyholders pay the appropriate premiums required under the terms of their policies and enable us to monitor payroll patterns or aberrations that cause underwriting, safety or fraud concerns.

We believe that the higher premiums typically paid by our policyholders, together with our disciplined underwriting and safety, claims and audit services, provide us with the opportunity to earn attractive returns on equity.

We completed our initial public offering in November 2005. In the offering, we issued 8,000,000 shares of common stock at $9.00 per share. Upon the completion of the offering, we issued an additional 9,120,948 shares of common stock in exchange for shares of our Series A preferred stock. Of the $63.2 million of net proceeds from this offering, we contributed $45.0 million to our insurance subsidiaries and used $10.2 million to redeem shares of our preferred stock. We expect to use the balance of the net proceeds to make additional capital contributions to our insurance subsidiaries as necessary to support our anticipated growth and for general corporate purposes.

In November 2006, we completed a public offering of 9,071,576 shares of common stock. All of these shares were offered by existing shareholders. We did not receive any of the proceeds from this offering.

AMERISAFE is an insurance holding company and was incorporated in Texas in 1985. We began operations in 1986 by focusing on workers compensation insurance for logging contractors in the southeast United States. In 1994, we expanded our focus to include the other hazardous industries we serve today. Two of our three insurance subsidiaries, American Interstate Insurance Company and Silver Oak Casualty, are domiciled in Louisiana. Our other insurance subsidiary, American Interstate Insurance Company of Texas, is domiciled in Texas.

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Competitive Advantages

We believe we have the following competitive advantages:

Focus on Hazardous Industries. We have extensive experience insuring employers engaged in hazardous industries and have a history of profitable underwriting in these industries. Our specialized knowledge of these hazardous industries helps us better serve our policyholders, which leads to greater employer loyalty and policy retention. Our policy renewal rate on voluntary business that we elected to quote for renewal was 91.1% in 2006, 90.6% in 2005 and 93.0% in 2004.

Focus on Small to Mid-Sized Employers. We believe large insurance companies generally do not target small to mid-sized employers in hazardous industries due to their smaller premium size, type of operations, mobile workforce and extensive service needs. We provide enhanced customer services to our policyholders. For example, unlike many of our competitors, our premium payment plans enable our policyholders to better match their premium payments with their payroll costs.

Specialized Underwriting Expertise. Based on our 21-year underwriting history of insuring employers engaged in hazardous industries, we have developed industry specific risk analysis and rating tools to assist our underwriters in risk selection and pricing. We are highly disciplined when quoting and binding new business. We do not delegate underwriting authority to agencies that sell our insurance or to any other third party.

Comprehensive Safety Services. We provide proactive safety reviews of employers worksites, which are often located in rural areas. These safety reviews are a vital component of our underwriting process and also assist our policyholders in loss prevention and encourage the safest workplaces possible by deploying experienced field safety professionals, or FSPs, to our policyholders worksites. In 2006, more than 94.0% of our new voluntary business policyholders were subject to pre-quotation safety inspections. We perform periodic on-site safety surveys on all of our voluntary business policyholders.

Proactive Claims Management. Our employees manage substantially all of our open claims in-house utilizing our intensive claims management practices that emphasize a personal approach and quality, cost-effective medical treatment. We currently average 56 open indemnity claims per field case manager, or FCM, which we believe is significantly less than the industry average. We believe our claims management practices allow us to achieve a more favorable claim outcome, accelerate an employee s return to work, lessen the likelihood of litigation and more rapidly close claims, all of which ultimately lead to lower overall costs.

Strategy

We intend to pursue profitable growth and favorable returns on equity using the following strategies:

Expand in our Existing Markets. Our current market share in each of the six states where we derived 5.0% or more of our gross premiums written in 2006 did not exceed 5.0% of the workers compensation market in that state, based on data received from the National Association of Insurance Commissioners, or the NAIC. Competition in our target markets is fragmented by state and employer industry focus. We believe that our specialized underwriting expertise and safety, claims and audit services position us to profitably increase our market share in our existing principal markets, with minimal increase in field service employees.

Prudent and Opportunistic Geographic Expansion. While we actively market our insurance in 31states and the District of Columbia, 44.2% of our voluntary in-force premiums were generated in the six states where we derived 5% or more of our gross premiums written in 2006. We are licensed in an additional 14 states and the U.S. Virgin Islands. Our existing licenses and rate filings will expedite our ability to write policies in these markets when we decide it is prudent to do so. In late 2006, we expanded our operations into selected areas of Nevada and Colorado.

Focus on Underwriting Profitability. We intend to maintain our underwriting discipline and profitability throughout market cycles. Our strategy is to focus on underwriting workers compensation insurance in hazardous industries and to maintain adequate rate levels commensurate with the risks we underwrite. We will also continue to strive for improved risk selection and pricing, as well as reduced frequency and severity of claims through comprehensive workplace safety reviews, effective medical cost containment measures and rapid closing of claims through personal, direct contact with our policyholders and their employees.

Leverage Existing Information Technology. We believe our customized information system, ICAMS, significantly enhances our ability to select risk, write profitable business and cost-effectively administer our billing, claims and audit functions. We also believe our infrastructure is scalable and will enable us to accommodate our anticipated premium growth at current staffing levels and at minimal cost, which should have a positive effect on our expense ratio over time as we grow our premium base.

Maintain Capital Strength. We plan to manage our capital to achieve our growth and profitability goals while maintaining a prudent operating leverage for our insurance company subsidiaries. To accomplish this objective, we intend to maintain underwriting profitability throughout market cycles, use a substantial portion of the proceeds of our initial public offering toward the judicious growth of our business, optimize our use of reinsurance and maximize an appropriate risk adjusted return on our growing investment portfolio.

Industry

Overview. Workers compensation is a statutory system under which an employer is required to pay for its employees medical, disability, vocational rehabilitation and death benefit costs for work-related injuries or illnesses. Most employers satisfy this requirement by purchasing workers compensation insurance. The principal concept underlying workers compensation laws is that employees injured in the course and scope of their employment have only the legal remedies available under workers compensation laws and do not have any other recourse against their employer. An employer s obligation to pay workers compensation does not depend on any negligence or wrongdoing on the part of the employer and exists even for injuries that result from the negligence or fault of another person, a co-employee or, in most instances, the injured employee.

Workers compensation insurance policies generally provide that the insurance carrier will pay all benefits that the insured employer may become obligated to pay under applicable workers compensation laws. Each state has a regulatory and adjudicatory system that quantifies the level of wage replacement to be paid, determines the level of medical care required to be provided and the cost of permanent impairment and specifies the options in selecting medical providers available to the injured employee or the employer. These state laws generally require two types of benefits for injured employees: (1) medical benefits, which include expenses related to diagnosis and treatment of the injury, as well as any required rehabilitation, and (2) indemnity payments, which consist of temporary wage replacement, permanent disability payments and death benefits to surviving family members. To fulfill these mandated financial obligations, virtually all employers are required to purchase workers compensation insurance or, if permitted by state law or approved by the U.S. Department of Labor, to self-insure. The employers may purchase workers compensation insurance from a private insurance carrier, a state-sanctioned assigned risk pool or a self-insurance fund, which is an entity that allows employers to obtain workers compensation coverage on a pooled basis, typically subjecting each employer to joint and several liability for the entire fund.

Workers compensation was the fourth-largest property and casualty insurance line in the United States in 2005, according to A.M. Best. Direct premiums written in 2005 for the workers compensation insurance industry were $56 billion, and direct premiums written for the property and casualty industry as a whole were $489 billion, according to A.M. Best. According to the most recent market data reported by the National Council on Compensation Insurance, Inc., or the NCCI, which is the official ratings bureau in the majority of states in which we are licensed, total premiums reported for the specific occupational class codes for which we underwrite business was $16 billion. Total premiums reported for all occupational class codes reported by the NCCI for these same jurisdictions was $39 billion.

Outlook. We believe the challenges faced by the workers compensation insurance industry over the past decade have created significant opportunity for workers compensation insurers to increase the amount of business that they write. The year 2002 marked the first year in five years that private carriers in the property and casualty insurance industry experienced an increase in annual after-tax returns on surplus, including capital gains, according to NCCI. Workers compensation insurance industry calendar year combined ratios declined for the first time in seven years, falling from 122% (with 1.9% attributable to the September 11, 2001 terrorist attacks) to 105% in 2004 as premium rates have increased and claims frequency has declined. In addition, claims frequency has declined. From 1991 through 2004, the cumulative decline in lost-time claims frequency was 45.8%. The NCCI estimates that lost-time claims frequency declined an additional 4.5% in 2005. We believe that opportunities remain for us to provide needed underwriting capacity at attractive rates and upon terms and conditions more favorable to insurers than in the past.

Policyholders

As of December 31, 2006, we had more than 6,800 voluntary business policyholders with an average annual workers compensation policy premium of $40,673. As of December 31, 2006, our ten largest voluntary business policyholders accounted for 2.6% of our in-force premiums. Our policy renewal rate on voluntary business that we elected to quote for renewal was 91.1% in 2006, 90.6% in 2005 and 93.0% in 2004.

In addition to our voluntary workers compensation business, we underwrite workers compensation policies for employers assigned to us and assume reinsurance premiums from mandatory pooling arrangements, in each case to fulfill our obligations under residual market programs implemented by the states in which we operate. In addition, we separately underwrite general liability insurance policies for our workers compensation policyholders in the logging industry on a select basis. Our assigned risk business fulfills our statutory obligation to participate in residual market plans in six states. See Regulation Residual Market Programs below. For the year ended December 31, 2006, our assigned risk business accounted for 3.6% of our gross premiums written, and our assumed premiums from mandatory pooling arrangements accounted for 1.3% of our gross premiums written. In addition, our general liability insurance business accounted for 0.7% of our gross premiums written for the year ended December 31, 2006.

Targeted Industries

We provide workers compensation insurance primarily to employers in the following targeted hazardous industries:

Construction. Includes a broad range of operations such as highway and bridge construction, building and maintenance of pipeline and powerline networks, excavation, commercial construction, roofing, iron and steel erection, tower erection and numerous other specialized construction operations. In 2006, our average policy premium for voluntary workers compensation within the construction industry was $42,338, or $7.78 per $100 of payroll.

Trucking. Includes a large spectrum of diverse operations including contract haulers, regional and local freight carriers, special equipment transporters and other trucking companies that conduct a variety of short- and long-haul operations. In 2006, our average policy premium for voluntary workers compensation within the trucking industry was $47,097, or $7.61per $100 of payroll.

Logging. Includes tree harvesting operations ranging from labor intensive chainsaw felling and trimming to sophisticated mechanized operations using heavy equipment. In 2006, our average policy premium for voluntary workers compensation within the logging industry was $21,182, or $17.02 per $100 of payroll.

Agriculture. Including crop maintenance and harvesting, grain and produce operations, nursery operations, meat processing and livestock feed and transportation. In 2006, our average policy premium for voluntary workers compensation within the agricultural industry was $28,651, or $9.35 per $100 of payroll.

Oil and Gas. Including various oil and gas activities including gathering, transportation, processing, production and field service operations. In 2006, our average policy premium for voluntary workers compensation within the oil and gas industry was $58,860, or $5.77 per $100 of payroll.

Maritime. Including ship building and repair, pier and marine construction, inter-coastal construction and stevedoring. In 2006, our average policy premium for voluntary workers compensation within the maritime industry was $55,787, or $9.24 per $100 of payroll.

Sawmills. Including sawmills and various other lumber-related operations. In 2006, our average policy premium for the sawmill industry was $30,654, or $7.27 per $100 of payroll.

Our gross premiums are derived from:

Direct Premiums. Includes premiums from workers compensation and general liability insurance policies that we issue to:

- employers who seek to purchase insurance directly from us and who we voluntarily agree to insure, which we refer to as our voluntary business; and
- employers assigned to us under residual market programs implemented by some of the states in which we operate, which we refer to as our assigned risk business.

Assumed Premiums. Includes premiums from our participation in mandatory pooling arrangements under residual market programs implemented by some of the states in which we operate.

In addition to workers compensation insurance, we also offer general liability insurance coverage only to our workers compensation policyholders in the logging industry on a select basis. As of December 31, 2006, less than 1.0% of our voluntary in-force premiums were derived from general liability policies.

Gross premiums written during the years ended December 31, 2006, 2005 and 2004 and the allocation of those premiums among the hazardous industries we target are presented in the table below.

	Gross Premiums Written			Percentage of Gross Premiums Written		
	2006	2005	2004	2006	2005	2004
	(In thousands)					
Voluntary business:						
Construction	$ 132,083	$ 117,134	$ 101,298	39.7%	40.3%	38.3%
Trucking	70,221	59,348	57,822	21.1%	20.4%	21.8%
Logging	24,553	26,324	30,340	7.4%	9.0%	11.5%
Agriculture	13,681	13,119	11,203	4.1%	4.5%	4.2%
Oil and Gas	10,578	8,035	7,226	3.2%	2.8%	2.7%
Maritime	9,180	7,262	5,909	2.8%	2.5%	2.2%
Sawmills	4,260	4,441	5,566	1.3%	1.5%	2.1%
Other	51,547	34,382	28,117	15.5%	11.8%	10.6%
Total voluntary business	316,103	270,045	247,481	95.1%	92.8%	93.4%
Assigned risk business	11,936	13,924	9,431	3.6%	4.8%	3.6%
Assumed premiums	4,452	6,922	8,050	1.3%	2.4%	3.0%
Total	$ 332,491	$ 290,891	$ 264,962	100.0%	100.0%	100.0%

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Geographic Distribution

We are licensed to provide workers compensation insurance in 45 states, the District of Columbia and the U.S. Virgin Islands. We operate on a geographically diverse basis with no more than 9.1% of our gross premiums written in 2006 derived from any one state. The table below identifies, for the years ended December 31, 2006, 2005 and 2004, the states in which the percentage of our gross premiums written exceeded 3.0% for any of the years presented.

	Percentage of Gross Premiums Written Year Ended December 31,		
State	**2006**	**2005**	**2004**
Georgia	9.1%	10.5%	9.5%
Louisiana	8.9%	8.3%	10.6%
North Carolina	7.5%	6.7%	6.3%
Florida	6.5%	5.9%	4.9%
Virginia	6.1%	5.3%	5.2%
Texas	5.8%	5.0%	6.5%
Pennsylvania	4.8%	5.3%	4.5%
Illinois	4.6%	5.4%	6.4%
South Carolina	4.5%	4.9%	4.6%
Alaska	4.4%	5.3%	4.4%
Minnesota	4.4%	4.2%	3.6%
Oklahoma	4.4%	4.1%	3.3%
Tennessee	4.2%	4.2%	3.9%
Mississippi	4.2%	3.5%	3.9%
Arkansas	3.8%	3.9%	4.7%
Wisconsin	2.9%	3.5%	3.3%

Sales and Marketing

We sell our workers compensation insurance through agencies. As of December 31, 2006, our insurance was sold through more than 2,400 independent agencies and our wholly owned insurance agency subsidiary, Amerisafe General Agency, which is licensed in 24 states. We are selective in establishing and maintaining relationships with independent agencies. We establish and maintain relationships only with those agencies that provide quality application flow from prospective policyholders that are reasonably likely to accept our quotes. We compensate these agencies by paying a commission based on the premium collected from the policyholder. Our average commission rate for our independent agencies was 6.9% for the year ended December 31, 2006. We pay our insurance agency subsidiary a commission rate of 8.0% . Neither our independent agencies nor our insurance agency subsidiary has authority to underwrite or bind coverage. We do not pay contingent commissions.

As of December 31, 2006, independent agencies accounted for 84.7% of our voluntary in-force premiums, and no independent agency accounted for more than 1.1% of our voluntary in-force premiums at that date.

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Underwriting

Our underwriting strategy is to focus on employers in certain hazardous industries that operate in those states where our underwriting efforts are the most profitable and efficient. We analyze each prospective policyholder on its own merits relative to known industry trends and statistical data. Our underwriting guidelines specify that we do not write workers compensation insurance for certain hazardous activities, including sub-surface mining and the use of explosives.

Underwriting is a multi-step process that begins with the receipt of an application from one of our agencies. We initially review the application to confirm that the prospective policyholder meets certain established criteria, including that it is engaged in one of our targeted hazardous industries and industry classes and operates in the states we target. If the application satisfies these criteria, the application is forwarded to our underwriting department for further review.

Our underwriting department reviews the application to determine if the application meets our underwriting criteria and whether all required information has been provided. If additional information is required, the underwriting department requests additional information from the agency. This initial review process is generally completed within three days after the application is received by us. Once this initial review process is complete, our underwriting department requests that a pre-quotation safety inspection be performed.

After the pre-quotation safety inspection has been completed, our underwriting professionals review the results of the inspection to determine if a rate quote should be made and, if so, prepare the quote. The rate quote must be reviewed and approved by our underwriting department before it is delivered to the agency. All decisions by our underwriting department, including decisions to decline applications, are subject to review and approval by our management-level underwriters.

Our underwriting professionals participate in an incentive compensation program under which bonuses are paid quarterly based upon achieving premium underwriting volume and loss ratio targets. The determination of whether targets have been satisfied is made 30 months after the relevant incentive compensation period.

Pricing

In the majority of states, workers compensation insurance rates are based upon the published loss costs. Loss costs are derived from wage and loss data reported by insurers to the state s statistical agent, in most states the NCCI. The state agent then promulgates loss costs for specific job descriptions or class codes. Insurers file requests for adoption of a loss cost multiplier, or LCM, to be applied to the loss costs to support operating costs and profit margins. In addition, most states allow pricing flexibility above and below the filed LCM, within certain limits.

We obtain approval of our rates, including our LCMs, from state regulatory authorities. To maintain rates at profitable levels, we regularly monitor and adjust our LCMs. The effective LCM for our voluntary business was 1.54 for 2006, 1.56 for policy year 2005, 1.53 for policy year 2004, 1.43 for policy year 2003, and 1.37 for policy year 2002. If we are unable to charge rates in a particular state or industry to produce satisfactory results, we seek to control and reduce our premium volume in that state or industry and redeploy our capital in other states or industries that offer greater opportunity to earn an underwriting profit.

Safety

Our safety inspection process begins with a request from our underwriting department to perform a pre-quotation safety inspection. Our safety inspections focus on a prospective policyholder s operations, loss exposures and existing safety controls to prevent potential losses. The factors considered in our inspection include employee experience, turn-over, training, previous loss history and corrective actions, and workplace conditions, including equipment condition and, where appropriate, use of fall protection, respiratory protection or other safety devices. Our field safety professionals, or FSPs, travel to employers worksites to perform these safety inspections. This initial in-depth analysis allows our underwriting professionals to make decisions on both insurability and pricing. In certain circumstances, we will agree to provide workers compensation insurance only if the employer agrees to implement and maintain the safety management practices that we recommend. In 2006, more than 94% of our new voluntary business policyholders were inspected prior to our offering a premium quote. The remaining voluntary business policyholders were not inspected prior to a premium quote for a variety of reasons, including small premium size or the policyholder was previously a policyholder subject to our safety inspections.

After an employer becomes a policyholder, we continue to emphasize workplace safety through periodic workplace visits, assisting the policyholder in designing and implementing enhanced safety management programs, providing current industry-specific safety-related information and conducting rigorous post-accident management. Generally, we may cancel or decline to renew an insurance policy if the policyholder does not implement or maintain reasonable safety management practices that we recommend.

Our FSPs participate in an incentive compensation program under which bonuses are paid quarterly based upon an FSP s production and their policyholders aggregate loss ratios. The results are measured 30 months after the inception of the subject policy period.

Claims

We have structured our claims operation to provide immediate, intensive and personal management of all claims to guide injured employees through medical treatment, rehabilitation and recovery with the primary goal of returning the injured employee to work as promptly as practicable. We seek to limit the number of claim disputes with injured employees through early intervention in the claims process.

We have claims offices located throughout the markets we serve. Our field case managers, or FCMs, are located in the geographic areas where our policyholders are based. We believe the presence of our FCMs in the field enhances our ability to guide an injured employee to the appropriate conclusion in a friendly, dignified and supportive manner. Our FCMs have broad authority to manage claims from occurrence of a workplace injury through resolution, including authority to retain many different medical providers at our expense, including not only our recommended medical providers but also nurse case managers, independent medical examiners, vocational specialists, rehabilitation specialists and other specialty providers of medical services necessary to achieve a quality outcome.

Following notification of a workplace injury, an FCM will contact the policyholder, the injured employee and/or the treating physician to determine the nature and severity of the injury. If a serious injury occurs, the FCM will promptly visit the injured employee or the employee s family members to discuss the benefits provided and will also visit the treating physician to discuss the proposed treatment plan. Our FCM assists the injured employee in receiving appropriate medical treatment and encourages the use of our recommended medical providers and facilities. For example, our FCM may suggest that a treating physician refer an injured worker to another physician or treatment facility that we believe has had positive outcomes for other workers with similar injuries. We actively monitor the number of open cases handled by a single FCM in order to maintain focus on each specific injured employee. As of December 31, 2006, we averaged 56 open indemnity claims per FCM, which we believe is significantly less than the industry average.

Locating our FCMs in the field also allows us to build professional relationships with local medical providers. In selecting medical providers, we rely, in part, on the recommendations of our FCMs who have developed professional relationships within their geographic areas. We also seek input from our policyholders and other contacts in the markets that we serve. While cost factors are considered in selecting medical providers, we consider the most important factor in the selection process to be the medical provider s ability to achieve a quality outcome. We define quality outcome as the injured worker s rapid, conclusive recovery and return to sustained, full capacity employment.

While we seek to promptly settle valid claims, we also aggressively defend against claims we consider to be non-meritorious. Where possible, we purchase annuities on longer life claims to close the claim while still providing an appropriate level of benefits to an injured employee.

Premium Audits

We conduct premium audits on all of our voluntary business policyholders annually, upon the expiration of each policy, including when the policy is renewed. The purpose of these audits is to verify that policyholders have accurately reported their payroll expenses and employee job classifications, and therefore have paid us the premium required under the terms of their policies. In addition to annual audits, we selectively perform interim audits on certain classes of business if significant or unusual claims are filed or if the monthly reports submitted by a policyholder reflect a payroll pattern or other aberrations that cause underwriting, safety or fraud concerns. We also mitigate against potential losses from underreporting of premium or delinquent premium payment by collecting a deposit from the policyholder at the inception of the policy, typically representing 15% of the total estimated annual premium, which deposit can be utilized to offset losses from non-payment of premium.

Loss Reserves

We record reserves for estimated losses under insurance policies that we write and for loss adjustment expenses related to the investigation and settlement of policy claims. Our reserves for loss and loss adjustment expenses represent the estimated cost of all reported and unreported loss and loss adjustment expenses incurred and unpaid at a given point in time. In establishing our reserves, we do not use loss discounting, which involves recognizing the time value of money and offsetting estimates of future payments by future expected investment income. Our process and methodology for estimating reserves applies to both our voluntary and assigned risk business and does not include our reserves for mandatory pooling arrangements. We record reserves for mandatory pooling arrangements as those reserves are reported to us by the pool administrators. We use a consulting actuary to assist in the evaluation of the adequacy of our reserves for loss and loss adjustment expenses.

When a claim is reported, we establish an initial case reserve for the estimated amount of our loss based on our estimate of the most likely outcome of the claim at that time. Generally, a case reserve is established within 14 days after the claim is reported and consists of anticipated medical costs, indemnity costs and specific adjustment expenses, which we refer to as defense and cost containment expenses, or DCC expenses. At any point in time, the amount paid on a claim, plus the reserve for future amounts to be paid, represents the estimated total cost of the claim, or the case incurred amount. The estimated amount of loss for a reported claim is based upon various factors, including:

- type of loss;
- severity of the injury or damage;
- age and occupation of the injured employee;
- estimated length of temporary disability;
- anticipated permanent disability;
- expected medical procedures, costs and duration;

- our knowledge of the circumstances surrounding the claim;
- insurance policy provisions related to the claim, including coverage;
- jurisdiction of the occurrence; and
- other benefits defined by applicable statute.

The case incurred amount can vary due to uncertainties with respect to medical treatment and outcome, length and degree of disability, employment availability and wage levels and judicial determinations. As changes occur, the case incurred amount is adjusted. The initial estimate of the case incurred amount can vary significantly from the amount ultimately paid, especially in circumstances involving severe injuries with comprehensive medical treatment. Changes in case incurred amounts, or case development, is an important component of our historical claim data.

In addition to case reserves, we establish reserves on an aggregate basis for loss and DCC expenses that have been incurred but not reported, or IBNR. Our IBNR reserves are also intended to provide for aggregate changes in case incurred amounts as well as the unpaid cost of recently reported claims for which an initial case reserve has not been established.

The third component of our reserves for loss and loss adjustment expenses is our adjusting and other reserve, or AO reserve. Our AO reserve is established for the costs of future unallocated loss adjustment expenses for all known and unknown claims. Our AO reserve covers primarily the estimated cost of administering claims. The final component of our reserves for loss and loss adjustment expenses is the reserve for mandatory pooling arrangements.

In establishing reserves, we rely on the analysis of our more than 148,000 claims in our 21-year history. Using statistical analyses and actuarial methods, we estimate reserves based on historical patterns of case development, payment patterns, mix of business, premium rates charged, case reserving adequacy, operational changes, adjustment philosophy and severity and duration trends.

We review our reserves by industry and state on a quarterly basis. Individual open claims are reviewed more frequently by our field case managers and adjustments to case incurred amounts are made based on expected outcomes. The number of claims reported or occurring during a period, combined with a calculation of average case incurred amounts, and measured over time, provide the foundation for our reserve estimates. In establishing our reserve estimates, we use historical trends in claim reporting timeliness, frequency of claims in relation to earned premium or covered payroll, premium rate levels charged and case development patterns. However, the number of variables and judgments involved in establishing reserve estimates, combined with some random variation in loss development patterns, results in uncertainty regarding projected ultimate losses. As a result, our ultimate liability for loss and loss adjustment expenses may be more or less than our reserve estimate.

Our analysis of our historical data provides the factors we use in our statistical and actuarial analysis in estimating our loss and DCC expense reserve. These factors are primarily measures over time of claims reported, average case incurred amounts, case development, duration, severity and payment patterns. However, these factors cannot be directly used as these factors do not take into consideration changes in business mix, claims management, regulatory issues, medical trends, employment and wage patterns and other subjective factors. We use this combination of factors and subjective assumptions in the use of the following six actuarial methodologies:

- Paid Development Method uses historical, cumulative paid losses by accident year and develops those actual losses to estimated ultimate losses based upon the assumption that each accident year will develop to estimated ultimate cost in a manner that is analogous to prior years.

- Paid Cape Cod Method multiplies estimated ultimate claims for each accident year by a weighted average, trended severity. The estimated ultimate claims used in this method are based on paid claim count development. The selected severity for a given accident year is then derived by giving some weight to all of the accident years in the experience history rather than treating each accident year independently.

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- Paid Bornhuetter-Ferguson (BF) Method a combination of the Paid Development Method and the Paid Cape Cod Method, the Paid BF Method estimates ultimate losses by adding actual paid losses and projected, future unpaid losses. The amounts produced are then added to cumulative paid losses to produce the final estimates of ultimate incurred losses.

- Incurred Development Method uses historical, cumulative incurred losses by accident year and develops those actual losses to estimated ultimate losses based upon the assumption that each accident year will develop to estimated ultimate cost in a manner that is analogous to prior years.

- Incurred Cape Cod Method multiplies estimated ultimate claims for each accident year by a weighted average, trended severity. The estimated ultimate claims used in this method are based on incurred claim count development. The selected severity for a given accident year is then derived by giving some weight to all of the accident years in the experience history rather than treating each accident year independently.

- Incurred Bornhuetter-Ferguson Method a combination of the Incurred Development Method and the Incurred Cape Cod Method, the Incurred BF Method estimates ultimate losses by adding actual incurred losses and projected, future unreported losses. The amounts produced are then added to cumulative incurred losses to produce an estimate of ultimate incurred losses.

For each method, we calculate the amount of our total loss and DCC expenses that we estimate will ultimately be paid by our reinsurers, which is subtracted from our total gross reserve to produce our total net reserve. We then analyze the results and may emphasize or deemphasize some or all of the outcomes to reflect our judgment of their reasonableness in relation to supplementary information and operational and industry changes. These outcomes are then aggregated to produce a single weighted average point estimate that is the base estimate for net loss and DCC expense reserves.

In determining the level of emphasis that may be placed on some or all of the methods, we review statistical information as to which methods are most appropriate, whether adjustments are appropriate within the particular methods, and if results produced by each method include inherent bias reflecting operational and industry changes. This supplementary information may include:

- open and closed claim counts;

- statistics related to open and closed claim count percentages;

- claim closure rates;

- changes in average case reserves and average loss and loss adjustment expenses incurred on open claims;

- reported and ultimate average case incurred changes;

- reported and projected ultimate loss ratios; and

- loss payment patterns.

In establishing our AO reserves, we review our past adjustment expenses in relation to paid claims and estimated future costs based on expected claims activity and duration.

The sum of our net loss and DCC expense reserve, our AO reserve and our reserve for mandatory pooling arrangements is our total net reserve for loss and loss adjustment expenses.

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As of December 31, 2006, our best estimate of our ultimate liability for loss and loss adjustment expenses, net of amounts recoverable from reinsurers, was $412.4 million, which includes $9.5 million in reserves for mandatory pooling arrangements as reported by the pool administrators. This estimate was derived from the process and methodology described above which relies on substantial judgment. There is inherent uncertainty in estimating our reserves for loss and loss adjustment expenses. It is possible that our actual loss and loss adjustment expenses incurred may vary significantly from our estimates.

As noted above, our reserve estimate is developed based upon our analysis of our historical data, and factors derived from that data, including claims reported, average claim amount incurred, case development, duration, severity and payment patterns, as well as subjective assumptions. We view our estimate of loss and DCC expenses as the most significant component of our reserve for loss and loss adjustment expenses.

We prepared a sensitivity analysis of our net loss and DCC expense reserve as of December 31, 2006 by analyzing the effect of reasonably likely changes to the assumptions used in deriving our estimates. Since the base estimate for our net loss and DCC expense reserve is derived from the outcomes of the six actuarial methodologies discussed above, the most significant assumption in establishing our reserve is the adjustment of and emphasis on those methods that we believe are most appropriate.

Of the six actuarial methods we use, three are incurred methods and three are paid methods. The selected development factors within each method are derived from our data and the design characteristics of the particular method. The six different methods each have inherent biases in their respective designs that are more or less predictive in their use. Incurred methods rely on historical development factors derived from changes in our incurred estimates of claims paid and reserve amounts over time, while paid methods focus on our claim payment patterns and ultimate paid costs. Incurred methods focus on the measurement of the adequacy of case reserves at points in time. As a result, if reserving practices change over time, the incurred methods may produce significant variation in the estimates of ultimate losses. Paid methods rely on actual claims payment patterns and therefore are not sensitive to changes in reserving practices.

The low end of the range of our sensitivity analysis was derived by placing more emphasis (63%) on the outcomes generated by the three paid methods and less emphasis (37%) on the outcomes generated by the three incurred methods. The high end of the range was derived by placing more emphasis (63%) on the outcomes generated by the three incurred methods and less emphasis (37%) on the outcomes generated by the three paid methods. We believe that changing the emphasis on the incurred and paid methods better reflects reasonably likely outcomes than adjusting selected development factors or other variables used within each method. We believe the results of this sensitivity analysis, which are summarized in the table below, constitute a reasonable range of the expected outcomes of our reserve for net loss and DCC expenses.

	As of December 31, 2006			
	Loss and DCC Expenses	AO	Mandatory Pooling Arrangements	Total
	(In thousands)			
Low end of range	$ 351,250	$ 18,903	$ 9,478	$ 379,631
Net reserve	383,987	18,903	9,478	412,368
High end of range	384,580	18,903	9,478	412,961

The resulting range derived from this sensitivity analysis would have increased net reserves by $593,000 or decreased net reserves by $32.7 million, at December 31, 2006. The increase would have reduced net income and stockholders equity by $385,000. The decrease would have increased net income and stockholders equity by $21.3 million. A change in our net loss and DCC expense reserve would not have an immediate impact on our liquidity, but would affect cash flow in future periods as the losses are paid.

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Given the numerous factors and assumptions used in our estimate of reserves, and consequently this sensitivity analysis, we do not believe that it would be meaningful to provide more detailed disclosure regarding specific factors and assumptions and the individual effects of these factors and assumptions on our net reserves. Furthermore, there is no precise method for subsequently evaluating the impact of any specific factor or assumption on the adequacy of reserves, because the eventual deficiency or redundancy is affected by multiple interdependent factors.

Reconciliation of Loss Reserves

The table below shows the reconciliation of loss reserves on a gross and net basis for the years ended December 31, 2006, 2005 and 2004, reflecting changes in losses incurred and paid losses.

	Year Ended December 31,		
	2006	2005	2004
		(In thousands)	
Balance, beginning of period	$ 484,485	$ 432,880	$ 377,559
Less amounts recoverable from reinsurers on unpaid loss and loss adjustment expenses	120,232	189,624	194,558
Net balance, beginning of period	364,253	243,256	183,001
Add incurred related to:			
Current year	201,711	182,174	160,773
Prior years	(2,227)	8,673	13,413
Loss on Converium commutation		13,209	
Total incurred	199,484	204,056	174,186
Less paid related to:			
Current year	41,002	42,545	40,312
Prior years	110,367	96,620	73,619
Total paid	151,369	139,165	113,931
Add effect of Converium commutation (1)		56,106	
Net balance, end of period	412,368	364,253	243,256
Add amounts recoverable from reinsurers on unpaid loss and loss adjustment expenses	106,810	120,232	189,624
Balance, end of period	$ 519,178	$ 484,485	$ 432,880

(1) The total payment from Converium was $61.3 million, of which $56.1 million was for ceded reserves and

$5.2 million was for paid recoverables as of June 30, 2005.

Our gross reserves for loss and loss adjustment expenses of $519.2 million as of December 31, 2006 are expected to cover all unpaid loss and loss adjustment expenses as of that date. As of December 31, 2006, we had 5,694 open claims, with an average of $91,180 in unpaid loss and loss adjustment expenses per open claim. During the year ended December 31, 2006, 6,581 new claims were reported, and 6,942 claims were closed.

As of December 31, 2005, our gross reserves for loss and loss adjustment expenses were $484.5 million. The increase in our reserves from December 31, 2005 to December 31, 2006 was due to our premium growth during this time period, partially offset by favorable development in prior accident years. As of December 31, 2005, we had 6,055 open claims, with an average of $80,014 in unpaid loss and loss adjustment expenses per open claim. During the year ended December 31, 2005, 7,073 new claims were reported, and 6,702 claims were closed.

As of December 31, 2004, our gross reserves for loss and loss adjustment expenses were $432.9 million. The increase in our reserves from December 31, 2004 to December 31, 2005 was due to our premium growth during this time period, offset by an increase in paid loss and loss adjustment expenses related to prior years. As of December 31, 2004, we had 5,684 open claims, with an average of $76,158 in unpaid loss and loss adjustment expenses per open claim. During the year ended December 31, 2004, 7,015 new claims were reported, and 7,086 claims were closed.

Loss Development

The table below shows the net loss development for business written each year from 1996 through 2006. The table reflects the changes in our loss and loss adjustment expense reserves in subsequent years from the prior loss estimates based on experience as of the end of each succeeding year on a GAAP basis.

The first line of the table shows, for the years indicated, our liability including the incurred but not reported loss and loss adjustment expenses as originally estimated, net of amounts recoverable from reinsurers. For example, as of December 31, 1996, it was estimated that $44.0 million would be sufficient to settle all claims not already settled that had occurred on or prior to December 31, 1996, whether reported or unreported. The next section of the table sets forth the re-estimates in later years of incurred losses, including payments, for the years indicated. The next section of the table shows, by year, the cumulative amounts of loss and loss adjustment expense payments, net of amounts recoverable from reinsurers, as of the end of each succeeding year. For example, with respect to the net loss reserves of $44.0 million as of December 31, 1996, by December 31, 2006 (ten years later) $39.7 million had actually been paid in settlement of the claims that relate to liabilities as of December 31, 1996.

The cumulative redundancy/(deficiency) represents, as of December 31, 2006, the difference between the latest re-estimated liability and the amounts as originally estimated. A redundancy means that the original estimate was higher than the current estimate. A deficiency means that the current estimate is higher than the original estimate.

Analysis of Loss and Loss Adjustment Expense Reserve Development

	Year Ended December 31, (In thousands)										
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
eserve for ss and loss ljustment penses, net insurance coverables	$ 43,952	$ 55,096	$ 43,625	$ 72,599	$ 86,192	$ 119,020	$ 152,908	$ 183,001	$ 243,256	$ 364,253	$ 412,36
et reserve timated as :											
ne year ter	35,447	54,036	49,098	75,588	96,801	123,413	155,683	196,955	265,138	362,026	
wo years ter	34,082	60,800	50,764	82,633	98,871	116,291	168,410	217,836	262,601		
hree years ter	34,252	63,583	57,750	86,336	92,740	119,814	187,225	218,217			
our years ter	35,193	68,754	59,800	86,829	93,328	132,332	189,098				
ve years ter	38,318	69,610	60,074	87,088	101,417	134,836					
x years ter	38,339	70,865	61,297	90,156	104,716						
	39,459	70,684	61,578	91,170							

even years ter										
ght years ter	38,888	70,577	62,484							
ine years ter	39,249	71,023								
en years ter	39,654									
et umulative dundancy eficiency)	$ 4,298	$ (15,930)	$ (18,859)	$ (18,571)	$ (18,524)	$ (15,816)	$ (36,190)	$ (35,216)	$ (19,345)	$ 2,227

	Year Ended December 31,										
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	200
	(In thousands)										
ulative int of ve paid, f reserve veries, gh:											
year later	19,143	35,005	26,140	45,095	51,470	51,114	66,545	73,783	$ 40,514	$ 110,369	
years	27,843	46,735	37,835	62,141	62,969	71,582	101,907	65,752	97,091		
e years	30,766	54,969	45,404	67,267	70,036	84,341	73,391	99,829			
years	32,576	60,249	48,184	70,894	73,680	42,919	96,884				
years	34,765	62,361	50,045	72,744	38,939	59,194					
ears	35,313	64,296	50,831	58,809	49,141						
n years	36,367	64,659	51,863	62,550							
years	36,379	64,289	52,796								
years	35,870	65,002									
years	36,364										
eserve mber 31	$ 43,952	$ 55,096	$ 43,625	$ 72,599	$ 86,192	$ 119,020	$ 152,908	$ 183,001	$ 243,256	$ 364,253	$ 412
surance verables	9,525	12,463	37,086	183,818	293,632	264,013	193,634	194,558	189,624	120,232	106
s reserve cember 31	$ 53,477	$ 67,559	$ 80,711	$ 256,417	$ 379,824	$ 383,033	$ 346,542	$ 377,559	$ 432,880	$ 484,485	$ 519
timated ve	$ 39,654	$ 71,023	$ 62,484	$ 91,170	$ 104,716	$ 134,836	$ 189,098	$ 218,217	$ 262,601	$ 362,026	
stimated urance verables	26,733	34,133	123,405	282,099	385,387	347,701	274,487	217,689	178,213	115,076	
s timated ve	$ 66,387	$ 105,156	$ 185,889	$ 373,269	$ 490,103	$ 482,537	$ 463,585	$ 435,906	$ 440,814	$ 477,102	
	$ (12,910)	$ (37,597)	$ (105,178)	$ (116,852)	$ (110,279)	$ (99,504)	$ (117,043)	$ (58,347)	$ (7,934)	$ 7,383	

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lative
dancy
ciency)

Our net cumulative redundancy (deficiency) set forth in the table above is net of amounts recoverable from our reinsurers, including Reliance Insurance Company, one of our former reinsurers. In 2001, Reliance was placed under regulatory supervision by the Pennsylvania Insurance Department and was subsequently placed into liquidation. As a result, we recognized losses related to uncollectible amounts due from Reliance of $770,000 in 2005, $260,000 in 2004, $1.3 million in 2003, $2.0 million in 2002 and $17.0 million in 2001.

Investments

We derive net investment income from our invested assets. As of December 31, 2006, the carrying value of our investment portfolio, including cash and cash equivalents, was $665.5 million and the fair value of the portfolio was $659.7 million.

Our investment strategy is to maximize after tax income and total return on invested assets while maintaining high quality and low risk investments within the portfolio. We pay investment management fees based on the market value of assets under management. The investment committee of our board of directors has established investment guidelines and periodically reviews portfolio performance for compliance with our guidelines.

In 2006 we began a strategic review of our investment management and related policies. As a result of this review, we retained Prudential Investment Management, Inc., a registered investment advisory firm and a subsidiary of Prudential Financial, Inc., to manage our portfolio of fixed maturity securities effective as of November 1, 2006. Prior to November 1, 2006, our investment portfolio was managed by Hibernia Asset Management, LLC.

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Additionally, our strategic investment review resulted in two changes regarding our equity investments. First, we changed the benchmark for the market value of our holdings of equity securities, from not more than 15% of our total investment portfolio, to a range from 20% to 30% of shareholders equity, plus redeemable preferred stock, at the end of the most recently completed fiscal year. Our second change was to restructure our equity portfolio such that it would be composed of passively managed investments in equity indexes along with a portion of actively managed equity positions. As a result of this second change, we sold all of the securities in our equity portfolio in September and October of 2006 and invested $21.1 million, or 11.5% of shareholders equity plus redeemable preferred stock at the end of the most recent fiscal year, into three value-based exchange traded funds. In 2007, we may purchase more index funds, or we may retain the services of a third-party equity portfolio manager to actively manage a portion of the equity portfolio.

See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Investments for further information on the composition and results of our investment portfolio.

The table below shows the carrying values of various categories of securities held in our investment portfolio, the percentage of the total carrying value of our investment portfolio represented by each category and the annualized tax-equivalent yield for the year ended December 31, 2006 based on the carrying value of each category as of December 31, 2006:

	Carrying Value (In thousands)	Percentage of Portfolio	Annualized Tax-Equivalent Yield
Fixed maturity securities:			
State and political subdivisions	$ 365,282	54.9%	5.9%
Mortgage-backed securities	117,456	17.6%	5.6%
U.S. Treasury securities and obligations of U.S. Government agencies	78,817	11.8%	5.2%
Corporate bonds	21,123	3.2%	5.2%
Asset-backed securities	32,436	4.9%	5.4%
Total fixed maturity securities	615,114	92.4%	5.7%
Equity securities	23,666	3.6%	2.0%
Cash and cash equivalents	26,748	4.0%	4.3%
Total investments, including cash and cash equivalents	$ 665,528	100%	

As of December 31, 2006, our fixed maturity securities had a carrying value of $615.1 million, which represented 92.4% of the carrying value of our investments, including cash and cash equivalents. For the 12 months ended December 31, 2006, the pre-tax investment yield of our investment portfolio was 4.1% per annum.

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The gross unrealized gains and losses on, and the cost and fair value of, our investment portfolio as of December 31, 2006 are summarized as follows:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(In thousands)		
Fixed maturity securities, held-to-maturity	$ 615,114	$ 1,294	$ 7,140	$ 609,268
Equity securities, available-for-sale	22,157	1,509		23,666
Totals	$ 637,271	$ 2,803	$ 7,140	$ 632,934

The amortized cost for the fixed maturity securities classified as held-to-maturity includes an unamortized gain of $4.7 million. This gain resulted in 2004 from the difference between each security s par value and fair value at the date of transfer from available-to-sale to held-to-maturity and is being amortized as a yield adjustment over the respective security s life.

The table below summarizes the credit quality of our fixed maturity securities as of December 31, 2006, as rated by Standard and Poor s.

Credit Rating	Percentage of Total Carrying Value
AAA	88.3%
AA	8.2%
A	2.2%
BBB	1.3%
Total	100.0%

As of December 31, 2006, the average composite rating of our fixed maturity securities was AAA. .

The table below shows the composition of our fixed maturity securities by remaining time to maturity as of December 31, 2006. For securities that are redeemable at the option of the issuer and have a carrying value that is greater than par value, the maturity used for the table below is the earliest redemption date. For securities that are redeemable at the option of the issuer and have a carrying value that is less than par value, the maturity used for the table below is the final maturity date.

	As of December 31, 2006	
Remaining Time to Maturity	Carrying Value (In thousands)	Percentage
Less than one year	$ 65,427	10.6%
One to five years	225,135	36.6%
Five to ten years	88,160	14.3%
More than ten years	86,500	14.1%
Mortgage-backed securities	117,456	19.1%
Asset-backed securities	32,436	5.3%

Total	$ 615,114	100.0%

Reinsurance

We purchase reinsurance to reduce our net liability on individual risks and claims and to protect against catastrophic losses. Reinsurance involves an insurance company transferring to, or ceding, a portion of the exposure on a risk to a reinsurer. The reinsurer assumes the exposure in return for a portion of our premium. The cost and limits of reinsurance we purchase can vary from year to year based upon the availability of quality reinsurance at an acceptable price and our desired level of retention. Retention refers to the amount of risk that we retain for our own account. Under excess of loss reinsurance, covered losses in excess of the retention level up to the limit of the program are paid by the reinsurer. Our excess of loss reinsurance is written in layers, in which our reinsurers accept a band of coverage up to a specified amount. Any liability exceeding the limit of the program reverts to us as the ceding company. Reinsurance does not legally discharge us from primary liability for the full amount due under our policies. However, our reinsurers are obligated to indemnify us to the extent of the coverage provided in our reinsurance agreements.

We believe reinsurance is critical to our business. Our reinsurance purchasing strategy is to protect against unforeseen and/or catastrophic loss activity that would adversely impact our income and capital base. We only select financially strong reinsurers with an A.M. Best rating of A (Excellent) or better at the time we enter into a reinsurance contract. In addition, to minimize our exposure to significant losses from reinsurer insolvencies, we evaluate the financial condition of our reinsurers and monitor concentrations of credit risk on a continual basis. We do not purchase finite reinsurance.

2007 Excess of Loss Reinsurance Treaty Program

Effective January 1, 2007, we entered into a new excess of loss reinsurance treaty program related to our voluntary and assigned risk business that applies to losses incurred between January 1, 2007 and the date on which our reinsurance agreements are terminated. Our reinsurance treaty program provides us with reinsurance coverage for each loss occurrence up to $50.0 million, subject to applicable deductibles, retentions and aggregate limits. However, for any loss occurrence involving only one claimant, our reinsurance coverage is limited to a maximum of $10.0 million for any single claimant for the first four layers and $5.0 million for any single claimant for the fifth layer, subject to applicable deductibles, retentions and aggregate limits. We currently have 16 reinsurers participating in our 2007 reinsurance treaty program. Under certain circumstances, including a downgrade of a reinsurer s A.M. Best rating to B++ (Very Good) or below, our reinsurers may be required to provide us with security for amounts due under the terms of our reinsurance program. This security may take the form of, among other things, cash advances or the issuance of letters of credit to us. If security is required because of a ratings downgrade, the form of security must be mutually agreed between the reinsurer and us.

Our 2007 reinsurance treaty program provides coverage in the following five layers:

First Layer. Affords coverage up to $3.0 million for each loss occurrence in excess of $2.0 million, which is retained by us. We are subject to an annual aggregate deductible of approximately $6.0 million for losses between $2.0 million and $5.0 million before our reinsurers are obligated to reimburse us. This layer also affords coverage for up to an aggregate of $3.0 million for certain losses caused by terrorism. The aggregate limit for all claims under this layer is approximately $51.0 million. The annual aggregate deductible and aggregate limit are calculated as a percentage of subject premium.

Second Layer. Affords coverage up to $5.0 million for each loss occurrence in excess of $5.0 million. The aggregate limit to all claims, including terrorism, under this layer is $15.0 million.

Third Layer. Affords coverage up to $10.0 million for each loss occurrence in excess of $10.0 million. The aggregate limit for all claims, including terrorism, under this layer is $20.0 million.

Fourth Layer. Affords coverage up to $10.0 million for each loss occurrence in excess of $20.0 million. The aggregate limit for all claims, including terrorism, under this layer is $20.0 million.

Fifth Layer. Affords coverage up to $20.0 million for each loss occurrence in excess of $30.0 million. The aggregate limit for all claims, including terrorism, under this layer is $40.0 million.

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The agreements under our 2007 reinsurance treaty program may be terminated by us or our reinsurers upon 90 days prior notice on any December 31. In addition, we may terminate the participation of one or more of our reinsurers under certain circumstances as permitted by the terms of our reinsurance agreements.

The table below sets forth the reinsurers participating in our 2007 reinsurance program:

Reinsurer	A.M. Best Rating
Allied World Assurance Company Ltd.	A
Aspen Insurance UK Limited	A
Arch Reinsurance Company	A
AXA RE	A
AXIS Reinsurance Company	A
BRIT Insurance Limited/Danish Re Underwriting Agencies ApS	A
BRIT Syndicates Limited (1)	A
Chaucer Syndicates Limited/Chaucer Underwriting (1)	A
Danish Re Syndicate/Danish Re Underwriting Agencies ApS (1)	A
Federal Insurance Company/Harbor Point Services, Inc.	A++
Hannover Ruckversicherungs-Aktiengesellschaft	A
Liberty Syndicate Management Limited (1)	A
M.J. Harrington Syndicate (1)	A
Partner Reinsurance Company of the U.S	A+
Tokio Millenium Re Ltd.	A+
XL Reinsurance America Inc.	A+

(1) Member of Lloyd s of London syndicate.

Due to the nature of reinsurance, we have receivables from reinsurers that apply to accident years prior to 2006. The table below summarizes our amounts recoverable from reinsurers as of December 31, 2006.

Reinsurer	A.M. Best Rating	Amount Recoverable as of December 31, 2006 (In thousands)
Munich Reinsurance America, Inc.	A	$ 23,737
Odyssey America Reinsurance Company	A	19,750
St. Paul Fire and Marine Insurance Company	A+	10,885
Clearwater Insurance Company	A	9,795
SCOR Reinsurance Company	A	7,144
Converium Reinsurance (North America)	B+	6,193
Hannover Ruckversicherungs-Aktiengesellschaft (1)	A	5,792
Aspen Insurance UK Limited (1)	A	5,643
Partner Reinsurance Company of the U.S (1)	A+	3,794
American National Insurance Company	A+	3,007
Other (22 reinsurers)		13,863
Total		$ 109,603

(1) Current participant in our 2007 reinsurance program.

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Terrorism Reinsurance

The Terrorism Risk Insurance Act of 2002 (the 2002 Act) was enacted in response to the events of September 11, 2001 and has been extended by the Terrorism Risk Insurance Extension Act of 2005 (the 2005 Act). Both the 2002 Act and the 2005 Act were designed to ensure the availability of insurance coverage for losses resulting from certain acts of terrorism in the United States. The 2005 Act continues a federal program established under the 2002 Act through the end of 2007. This program provides federal reimbursement to insurance companies for a portion of their losses arising from certain acts of terrorism and requires insurance companies to offer coverage for such acts. The program only applies to insured losses arising out of acts of terrorism committed on behalf of foreign persons or foreign interests that are certified as acts of terrorism by the Secretary of the Treasury. In addition, the program does not provide any reimbursement for any portion of aggregate industry-wide insured losses from certified acts of terrorism that exceed $100.0 billion in any one year and is subject to certain other limitations and restrictions.

For insured losses in 2007, each insurance company is responsible for a statutory deductible under the 2005 Act that is equal to 20% of its direct earned property and casualty insurance premiums. For losses occurring in 2007, the U.S. Federal Government will reimburse 85% of an insurance company s covered losses over the statutory deductible. In addition, no federal reimbursement is available unless the aggregate insurance industry-wide losses from a certified act of terrorism exceed $100.0 million for any act of terrorism occurring in 2007. However, there is no relief from the requirement under the 2005 Act that insurance companies offer coverage for certified acts of terrorism if those acts do not cause losses exceeding these threshold amounts and thus do not result in any federal reimbursement payments.

Under the 2005 Act, insurance companies must offer coverage for losses due to certified acts of terrorism in all their commercial property and casualty policies, including workers compensation policies. Moreover, even in the absence of this federal law requirement, the workers compensation laws of the various states generally do not permit the exclusion of coverage for losses arising from acts of terrorism, including terrorism that involves the use of nuclear, biological or chemical agents. In addition, state law prohibits us from limiting our workers compensation insurance losses arising from any one catastrophe or any one claimant. We have reinsurance protection in our 2007 reinsurance treaty program that affords coverage for up to $50 million for losses arising from terrorism or nuclear, biological and chemical attacks, subject to the deductibles, retentions and aggregate limits.

Technology

We view our internally developed and purchased management information systems as an integral part of our operations and make a substantial ongoing investment in improving our systems. We provide our field premium auditors, field safety professionals and field case managers with computer and communication equipment to more timely and efficiently complete the underwriting process. This technology also helps to facilitate communication and to report and monitor claims. All of our systems development and infrastructure operation and maintenance is performed by our information technology professionals, with limited assistance from outside vendors.

Core Systems

ICAMS. Our internally developed Insurance Claims and Accounting Management System, or ICAMS, is an application designed to support our workers compensation insurance business. ICAMS provides comprehensive rating, analysis, quotation, audit, claims, policy issuance and policy-level accounting transaction processes. By combining the information we obtain in our underwriting process with information on claims billing and claims management, we are able to enhance our services to our policyholders.

RealSafe. RealSafe is an internally developed application that supports our field safety professionals, as well as safety, claims and underwriting departments in our home office, by providing risk assessment and reporting of information to support safety and loss control initiatives.

CLAIMExpert. CLAIMExpert is a purchased application utilized by our claims department to assist in work flow management. The application distributes all claims-related mail to the appropriate FCM. This application allows for the use of multiple cost containment vendors and routes our claims-related invoices. CLAIMExpert also serves as the file repository for claims-related mail and documents and is web accessible by our authorized users.

Document Management System. Our document management system is a purchased application currently being used by our underwriting, audit, finance and treasury departments to scan, index and store imaged documents to facilitate the movement of work items from one authority level to the next. The system will ultimately include all departments. The system allows departmental management to closely monitor and modify employee workloads as needed.

Freedom Enterprise. FFS-Enterprise is a Fiserv product that functions as our general ledger and accounts payable systems using an MS SQL database platform. We also use Fiserv companion products for report writing, check printing and annual statement preparation. Transactions can be manually entered into Enterprise, interfaced via an ASCII file or copied and pasted from a spreadsheet application. Enterprise is currently set up to accept transaction detail by department, cost center, line of business and state. Enterprise also offers the capability of batch processing, which enables off-peak hour work.

Freedom Reinsurance System (FRS). FRS is a Fiserv product that provides ceded reinsurance processing. Functions performed by FRS include treaty information management, ceded loss billing and collection and reinsurance accounting.

Visual Audit. Visual Audit is a purchased application used by our field premium auditors to input information necessary to complete an interim or final premium audit.

Information Warehouse. Information Warehouse is an internally developed SQL Server-based set of OLAP cubes, queries and processes that extracts operational data from ICAMS and other of our applications and transforms that data for porting to Freedom Enterprise and *fnet.*

fnet. fnet is an internally developed data analysis portal. *fnet* is populated by our Information Warehouse, and used throughout our company to generate key performance statistics.

Operating Systems

We use Microsoft Active Directory services to provide application access, domain authentication and network services. Our server hardware is predominately Compaq/HP, but includes Dell servers as well. Our production servers are under manufacturer warranties.

Business Continuity/Disaster Recovery

Our Storage Area Network solution provides us with continuous operations using mirrored servers and storage situated in two separate corporate buildings, with built-in failover capabilities to minimize business interruption. We utilize software from Veritas for backup and recovery purposes. Full system backups are performed nightly using one on-site and one off-site facility for tape storage.

Competition

The insurance industry, in general, is highly competitive and there is significant competition in the workers compensation insurance industry. Competition in the insurance business is based on many factors, including premium rates, policy terms, coverage availability, claims management, safety services, payment terms, types of insurance offered, overall financial strength, financial ratings assigned by independent rating organizations, such as A.M. Best, and reputation. Some of the insurers with which we compete have significantly greater financial, marketing and management resources and experience than we do. We may also compete with new market entrants in the future.

We believe the workers   compensation market for the hazardous industries we target is und